Financial Markets

Irving Trust

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Economic Research &
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Friday
(Noon)

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Throughout the week, as the rate on Federal funds moved relentlessly toward the 20% area, financial markets struggled to extend (or at least to preserve) the gains of the last two weeks' rally. The market was supported by a variety of news items pointing to a slowing of the inflation rate and increased economic sluggishness--especially today's reports of a 4.8% increase in the Producer Price Index and a 0.3% rise in the unemployment rate, to 7.6%, in May. Taking some of the glow off the reports, however, were fairly widespread expectations of sizable increase in data on the monetary aggregates to be reported in coming weeks.

A comparison of the costs incurred by dealers financing their securities positions, which fortunately are considered to be relatively light at this time, vividly illustrates the pressures on the markets. Last Friday, Treasury securities could be financed under a repurchase agreement at about a 16% rate; today, the rate was about 20%. A week ago, three-month Treasury bills were yielding a bit over 16%, allowing a dealer to position the security with a small positive "carry," thus creating a small profit. Today, however, despite an increase in the yield on bills, the carry is massively negative--about -3%. Due to the sharply inverted yield curve, the situation is even more extreme in the long-term sector. The Treasury's 30-year long bond has been yielding a bit over 13% recently, producing a -3% carry a week ago, against a huge -7% today. Small wonder that dealers were nervous: It costs lots of money now to bet on lower inflation rates later. As indicated here last week, the rally near term must be regarded as vulnerable.

This week's operations by the Federal Reserve to drain reserves were largely of a technical nature. But they did make clear that, contrary to some expectations, the Fed had not materially eased its policy stance in reaction to the decelerating pattern of M-1B in the last several weeks. To understand why, recall that the Fed is giving more weight to M-2 these days, implying that improvement in M-1B must be discounted somewhat until confirmed by improvement in M-2. Moreover, for essentially technical reasons, the Fed is probably projecting a resurgence of money growth during this quarter, following the unusually sluggish growth in the first quarter of the year.

The rise of the funds rate appears to have been produced, not by any overt Fed tightening move, but rather by a movement of the funds rate to a more normal relation to the discount rate, which is probably approaching an effective 18% now, given the amount of net borrowed reserves that has existed in recent weeks.

William C. Melton

Note: The full text of the letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

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Market Yields

	6/5/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	20.00%	20.50%	13.00%
Effective since	6/2/81		
Discount Rate at Federal Reserve Bank	14.00	14.00	12.00
Federal Funds	20.25	17.50	10.50
Repurchase Agreements	20.25	16.00	10.25
U.S. Treasury Issues			
Bills			
3 months	16.75	16.11	7.50
6 months	16.25	15.61	7.98
1 year	15.40	15.16	8.29
Coupons			
2 years	14.75	14.68	8.85
4 years	14.35	14.25	9.30
7 years	13.80	13.78	9.70
10 years	13.55	13.54	9.88
Long Bond	13.10	13.13	10.00
Negotiable Certificates of Deposit-Secondary Market			
1 month	18.50	17.10	8.80
3 months	17.85	17.20	9.75
6 months	16.80	16.25	8.45
1 year	16.00	15.75	8.50
Banker's Acceptances			
1 month	19.30	17.25	8.70
3 months	17.75	16.95	8.50
6 months	16.70	16.35	8.35
Eurodollar Deposits			
1 month	19.25	18.00	9.69
2 months	18.75	18.00	9.75
3 months	18.63	18.00	9.75
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	18.25	16.50	8.00
1 month	17.75	16.25	8.00
3 months	16.00	15.75	7.75
Bank Holding Companies			
1 month	18.50	16.50	8.63
Dealer Placed:			
3 months	18.50	16.75	8.50
New AA Corporate Utility Bond	15.75	16.25	11.65
Tax Exempt			
6 month Project Notes	7.10	7.35	4.60
1 year AAA Bond	7.50	7.75	5.10
5 year AAA Bond	8.25	8.45	5.30
20 year AAA Bond	9.90	9.80	6.60

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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